Office of Chief Counsel Internal Revenue Service

memorandum

CC:LM:RFP:MIA:POSTF-110017-02 DRSmith

date: June 21, 2002

to: Cal Brown, Revenue Agent, LMSB Group 1716, Sarasota, FL

from: Associate Area Counsel. LMSB, Miami, FL

subject:

This memorandum discusses an issue which was discussed at our meeting at your office in Sarasota, FL on February 19, 2002, and which you raised in a January 28, 2002 memorandum to Partnership Technical Advisor Stewart Connard.

This memorandum should not be cited as precedent.

NOTE: On May 9, 2002, the office of Associate Chief Counsel (Passthroughs & Special Industries) issued a Field Service Advice memo in this case,

POSTF-162191-01, concluding that the shareholders of recognized income in in the total amount of in the form of deemed cash distributions pursuant to I.R.C. § 752(b), since their share of the liabilities of were decreased by this amount due to the fact that they were not liable in their individual capacities on the senior Notes issued as part of the service with the legal theory set forth in the FSA that I.R.C. § 752(b) is the preferable approach to take here.

ISSUE

(1) whether a transaction between
, a small business corporation owned
by and
, and a newly-formed entity,
LLC (""), which occurred on
, can properly be characterized as a disguised sale of
property from
(2) whether the Preferred A and B Interests, valued at \$
, transferred from to on
, were quaranteed payments or preferred returns, such

that they would not be part of a disguised sale of the operating assets from to ______?

For tax purposes, treated the contribution of the operating assets as a capital contribution from to within I.R.C. § 721, and the distribution of in equity interests and nonvoting preferred interests as a nontaxable distribution within I.R.C. § 731.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

COORDINATION

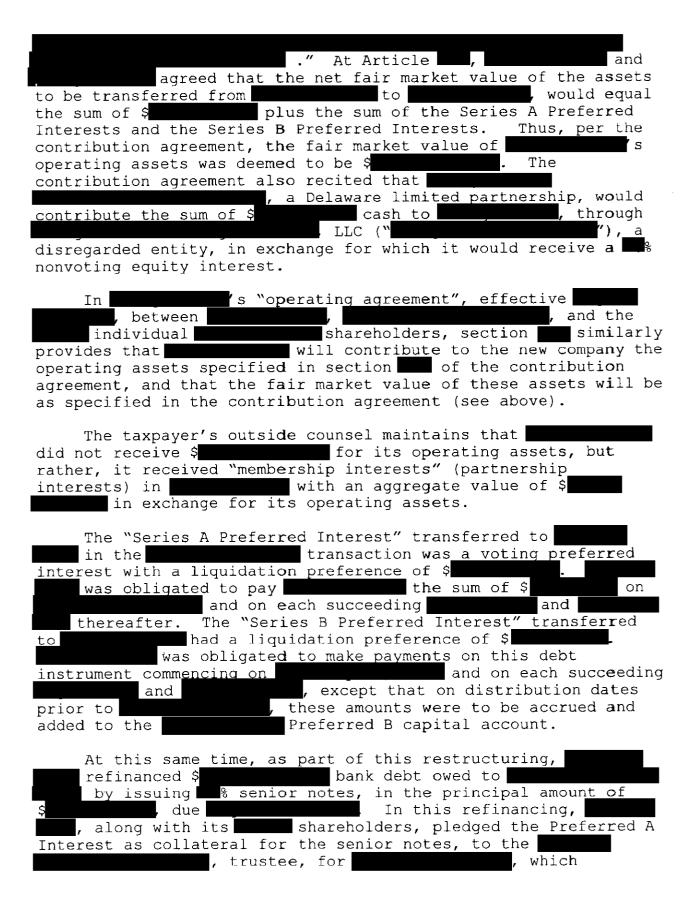
This memorandum has been coordinated with Partnership Technical Advisor Stewart Connard and Partnership Industry Counsel Shelia Harvey.

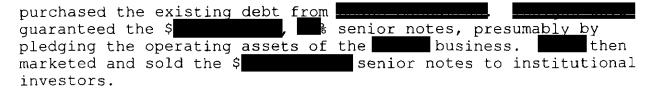
FACTS

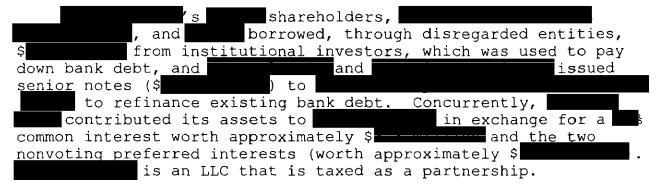
Prior to perated a pusiness in and the surrounding metropolitan area.

As part of a restructuring, on transferred all the operating assets of its business, in which it had an adjusted basis of \$, to newly-formed limited liability company. deemed this to be a "contribution" of property by a partner to a partnership, within I.R.C. § 721. also assumed the liabilities of the business. Pursuant to a Contribution Agreement, contributed its operating assets to the newly formed LLC in exchange for a non-voting common interest worth approximately \$, and two voting preferred interests (the "Series A Preferred Interest" and the "Series B Preferred Interest") which carried a liquidation preference of \$ and \$ respectively.

The Contribution Agreement states, at Article, that







LEGAL ANALYSIS

The general rule is that no gain or loss shall be recognized by a partnership or by any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. I.R.C. § 721(a). Also, in the case of a distribution by a partnership to a partner, gain shall not be recognized by the partner, except to the extent that any money distributed to the partner exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. I.R.C. § 731(a).

But Treas. Reg. § 1.731-1(c)(3) provides that if a distribution to a partner is made within a short time after a contribution of property to the partnership, in order to effect an exchange of property between the partner and the partnership, then the general rule of I.R.C. § 731 will not apply, and the transaction will be treated as a taxable sale or exchange of a partnership interest.

There have been some cases in which the Service, usually

without success, attempted to recharacterize the receipt of nontaxable distributions as "disguised sales". See, Otey v. Commissioner, 70 T.C. 312 (1978), aff'd. per curiam, 634 F.2d 1046 (6th Cir. 1980); Jupiter Corp. v. United States, 2 Cl. Ct. 58, 83-1 U.S.T.C. ¶ 9168 (Cl. Ct. 1983); Park Realty Co. v. Commissioner, 77 T.C. 412 (1981); Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980); Jacobson v. Commissioner, 96 T.C. 577 (1991); Oehlschlager v. Commissioner, T.C. Memo. 1988-210; Colonnade Condominium, Inc., v. Commissioner, 91 T.C. 793 (1988).

I.R.C. § 707(a)(2)(B)

I.R.C. § 707(a)(2)(B) was added to the Internal Revenue Code as part of the Deficit Reduction Act of 1984. This section applies where money or property is transferred, directly or indirectly, by a partner to a partnership, and there is a related direct or indirect transfer of property or money to that partner, or another partner, by the partnership. If such transfers, when viewed together, are properly characterized as a sale or exchange of property, they will be treated as a transaction between the partnership and a partner not acting in its capacity as a partner, or between partners acting other than as members of the partnership. The effect is to preclude the nonrecognition provisions of I.R.C. §§ 721 and 731, and treat the transaction as a taxable sale or exchange under I.R.C. § 1001. I.R.C. § 741 then provides that, in the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. This gain or loss is generally considered to be a gain or loss from the sale of a capital asset.

But a disguised sale analysis must also consider whether the transfers from to constituted either guaranteed payments or preferred returns. If so, then they are not treated as the proceeds of a disguised sale of the operating assets to the new LLC. Treas. Regs. § 1.707-4 contains special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursement of preformation expenditures.

GUARANTEED PAYMENTS FOR CAPITAL

I.R.C. § 707(c) states that payments to a partner for services or for the use of capital shall be considered as made to one who is not a member of the partnership, to the extent that such payments are made without regard to the income of the partnership. A "guaranteed payment" for capital can be defined as any payment to a partner by a partnership that is determined without regard to partnership income, and that is for the use of

the partner's capital. The payments are not made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership (the "cashing out" aspect of a disguised sale) rather than to provide the partner with a return on its investment in the partnership. But the regulations carve out exceptions to this general principle. Treas. Regs. § 1.707-4(a)(1)(ii) creates a presumption that a reasonable guaranteed payment made to a partner for the use of that partner's capital, without regard to partnership income, is not treated as part of a sale of property, for purposes of the disguised sale rules, unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale. a guaranteed payment is "reasonable" if it is made to the partner pursuant to a written partnership agreement, and if the amount to be paid to the partner for a particular year does not exceed an amount determined by multiplying the partner's unreturned capital at the beginning of the year by the safe harbor interest rate for that year.

From our analysis of the transaction and the associated documents, we think that the Series A and B Preferred Interests transferred to upon the formation of the new LLC 's capital, and that the were for the use of the amount and timing of the Series A and B Preferred Interests were determined without regard to partnership income (or loss). Thus, they appear to meet the definition of "quaranteed payments for capital". The parties stipulated in the Contribution Agreement and the Operating Agreement that the fair market value of the operating assets contributed by was \$ equal to the combined value of the equity interest and the principal amounts of the Series A and Series B Preferred Interests, a fact which tends to indicate that the Series A and B Preferred Interests were intended to be for the use of 's contributed capital. had a contractual obligation to make interest payments every months and to pay the principal at maturity, regardless of partnership income or loss, or partnership cash flow. The payments also seem to fit within the regulations' standard of reasonableness. Thus, we conclude that the transfer of the Series A and B Preferred were quaranteed Interests from to 's capital by the newlypayments for the use of formed entity.

PREFERRED RETURNS

The regulations contain substantially similar provisions for preferred returns. A "preferred return" can be defined as a preferential distribution of partnership cash flow to a partner

with respect to capital contributed to the partnership by the partner that will be matched by an allocation of income or gain. The regulations create a presumption that a transfer of money that is characterized by the parties as a preferred return, and that is reasonable, is not part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale. Treas. Reg. § 1.707-Based upon this test, if the transfer to of the Preferred A Interest and the Preferred B Interest constitute a reasonable preferred return, then they will not be treated as part of a sale of property by to From our analysis of the transaction, we do not think that the Preferred A and B interests transferred to within the definition of preferred returns, because they were not distributions of partnership cash flow, but rather fixed debt at fixed future dates, obligations to be paid to regardless of partnership cash flow. Further, these future payment(s) are unrelated to any allocation of partnership income or gain.

DISGUISED SALE

If the payments to be made to pursuant to the Series A and Series B Preferred Interests are not deemed to be guaranteed payments for capital, then a disguised sale analysis under I.R.C. § 707(a)(2)(B) and the regulations thereunder must be conducted.

Treas. Regs. § 1.707-3(b) provides that a transfer of property (other than money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale of property by the partner to the partnership only if (1) the transfer of money or other consideration would not have been made but for the transfer of property, and (2) in cases where the transfers are not simultaneous, the subsequent transfer is not dependent upon the risks of entrepreneurial operations. case, (1), above, applies, and since the transfers were made simultaneously, (2) is not applicable. The regulations then state that the determination of whether a transfer of property by a partner to the partnership and a related distribution constitute a disquised sale will be made on the basis of all the facts and circumstances. Treas. Reg. § 1.707-3(b)(2). The regulation then lists ten facts and circumstances to be considered in making the determination, as follows:

(i) the timing and amount of the subsequent transfer (the distribution to the partner) are determinable with reasonable certainty at the time of the earlier transfer (the contribution

by the partner);

- (ii) the transferor (partner) has a legally enforceable
 right to the subsequent transfer;
- (iii) the partner's right to receive the transfer of money or other consideration is secured;
- (iv) any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to be able to make the transfer to the partner;
- (v) any person has loaned or agreed to loan money to the partnership in order to enable the partnership to make the transfer, taking into account whether such lending obligation is subject to contingencies related to the results of partnership operations;
- (vi) the partnership has incurred or is obligated to incur debt to acquire the funds needed to permit it to make the transfer;
- (vii) the partnership holds money or other liquid assets, beyond its reasonable business needs, that are expected to be available to make the transfer;
- (viii) partnership distributions, allocations or control of partnership operations are designed to effect a change in the burdens and benefits of ownership of property;
- (ix) the transfer of money or other consideration by the partnership to the partner is disproportionately large in relation to the partner's interest in partnership profits and losses:
- (x) the partner has no obligation to return or repay the money to the partnership, or if it has such an obligation, it is so distant or remote that the present value of the obligation is very small in relation to the money transferred to the partner.

Where the transfers between a partnership and a partner are made within two years of each other, there is a rebuttable presumption that the transaction is a sale. Treas. Reg. § 1.707-3(c)(1).

¹ The maturity dates for payment of principal on the Series A and Series B Preferred Interests were outside the two-year period. However, the right to receive these payments was granted

The regulations issued under I.R.C. § 707(a)(2)(B) apply to transactions for which all transfers considered part of a sale occurred after April 24, 1991.

Applying the ten facts and circumstances listed in Treas.

Reg. § 1.707-3(b)(2) does not, in our view, provide a totally clear answer as to whether the transaction between and and can be recharacterized as a disguised sale of the operating assets of the business to the partnership.

The transfers here were done simultaneously, which tends to minimize the first factor set forth in the regulations, above.

The second factor clearly was present, since had a contractual right to receive the Series A and B Preferred

Interests as they matured, and interest payments every months until maturity.

's right to receive these interests was not secured, so the third factor was not present. The fourth and fifth factors also were not present.

The sixth factor does not literally apply, except that the partnership itself issued debt instruments to money or other consideration transferred. The seventh factor seems to be present, since the new LLC now owns the operating assets of the business, which should generate sufficient income to make the semi-annual interest payments, and should generate sufficient future income to pay the Preferred A and B Interests at their maturity dates. The eighth factor is not present, since the partnership distributions to not appear to have been designed to effect a transfer of the burdens and benefits of ownership. The ninth factor is present, since and its shareholders received \$ in money or other consideration in return for a equity ownership interest in the partnership, which interest was valued at \$ in the partnership documents. The tenth factor also was present, since had no obligation to repay the money or other consideration it received from the new LLC.

The disguised sale theory has some potential applicability under these facts. Following the guidelines set forth in the regulations, four of the ten "facts and circumstances" listed in Treas. Reg. § 1.707-3 (b) (2) of the regulations seem to be present here.

to simultaneously with its contribution of the operating assets to the newly-formed entity.

The theory set forth in your incoming memorandum is that, in exchange for contributing all the operating assets of the business, and its shareholders did not receive merely an equity interest in the partnership, but rather a relatively small equity interest, plus large installment notes payable in years. The theory is that this made a creditor, rather than a partner, of this theory, sold its operating assets, in which it had an adjusted basis of \$ to the partnership, for a equity interest and installment obligations worth \$ to the partnership.

On this issue, we found no cases directly on point. But cases have dealt with the question of whether a purported partner or joint venturer was really a creditor by virtue of receiving a debt instrument in return for its capital contribution to the venture or partnership. The key attributes of a partnership or joint venture have been held to be: (1) a contract or agreement that a partnership was to be formed; (2) the contribution of money, property or services by the partners; (3) an agreement for joint control; and (4) an agreement to share profits. S & M Plumbing Co., Inc., v. Commissioner, 55 T.C. 702 (1971); Podell v. Commissioner, 55 T.C. 429 (1971); Hartman v. Commissioner, T.C.M. 1958-206; Mayer v. Commissioner, T.C.M. 1954-14.

On the question of whether the transaction may have constituted a disguised sale of property (the operating assets) by the partner to the partnership due to the partner's receipt of preferred interests, again we found no cases directly on point. But <u>S & M Plumbing Co.</u>, <u>supra</u>, recognized the existence of a joint venture even though one of the parties had received a preferred stock interest, citing the clear intent of the parties to form a joint venture. The court was satisfied that the substance of the transaction was the formation of a joint venture, and not a debtor-creditor arrangement.

Based upon the foregoing analysis, it is our opinion that, under the facts and circumstances as presently known, the transaction cannot fairly be recharacterized as a disguised sale of property from to to under the guidelines set forth in Treas. Regs. § 1.707-3, and the available case law.

If you were to determine that the fair market value of the operating assets contributed to the new LLC by was significantly less than the \$\frac{1}{2} \text{figure stated by the parties to the transaction, such a fact might tend to show that the transfers by the partnership to were not guaranteed payments for capital, but rather the proceeds of a

disguised sale of property to the partnership. Also, we have not analyzed the partners' capital accounts in the new entity. Under the partnership documents, the other partner, would have a street in partnership profits or losses, with holding a street. Any shift in those relative interests in the partners' capital accounts might tend to show that a disguised sale had taken place.

At best, we think any disguised sale argument would be an alternative or backup legal position to be argued in this case, after the position based upon I.R.C. § 752(b) as set forth in the May 9, 2002 Field Service Advice memorandum.

CONCLUSION

- (1) the transfer of the \$ Series A and B Preferred Interests to was not part of a disguised sale of the operating assets of the business to
- (2) the transfer of the Series A and B Preferred Interests by were guaranteed payments for the use of s capital.

DAVID R. SMITH

Associate Area Counsel (LMSB)

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